Office of Chief Counsel
Internal Revenue Service

memorandum

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LRAverbeck

date: June 12, 2002

to: [redacted]
Team Manager, LMSB, [redacted]

from: Associate Area Counsel, LMSB
(Heavy Manufacturing and Transportation)

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subject: [redacted]
Check-the-box and Worthless Stock Deduction
Tax Periods: Tax Year Ending December 31, [redacted]

This is the revised version of the memorandum previously sent to you on May 13, 2002. It incorporates the advice of the National Office, but does not contain a substantial change in our position from the previously issued advice. This memorandum should not be cited as precedent.

ISSUE

Whether the taxpayer may claim a worthless stock deduction under section 165 and write off of bad debt under section 166 after making a "check-the-box" election under section 7701 to make a deemed liquidation of [redacted] foreign subsidiaries.

CONCLUSION

Under the facts of this case, the taxpayer may not claim a worthless stock deduction under section 165 or write off a bad debt loss under section 166 pursuant to a "check-the-box" election under section 7701 to make a deemed liquidation of three foreign subsidiaries.

FACTS

The taxpayer made an election, under section 7701, to disregard [redacted] of its foreign entities as separate entities. On its [redacted] income tax return, the taxpayer claimed bad debt and worthless stock losses for each of the [redacted] entities, claiming that all of the entities were insolvent. In response to IDRs, the taxpayer stated that, effective [redacted], [redacted] converted from a [redacted] to a [redacted]. [redacted] continues to operate under

[redacted] law as a [redacted]. Effective [redacted], [redacted] was converted to a branch pursuant to the United States check-the-box regulatory regime. [redacted] Ltd. continues to operate under [redacted] law as a proprietary company. Effective December 20, [redacted], [redacted] was merged into [redacted] LLC. [redacted] Ltd. ([redacted]) continues to operate under [redacted] law as a [redacted] (a newly established LLC). The check-the-box elections were made for the newly-formed entities [redacted], [redacted] Ltd. ([redacted]) and [redacted] Ltd.

In response to an IDR, [redacted] Corporation stated that each of the new foreign operations are expected to become profitable in the future.

The taxpayer asserts that under section 165 and 166, a parent corporation can take a bad debt and worthless stock deduction when an insolvent corporation is liquidated. The taxpayer's position is that each of the newly formed foreign entities was insolvent at the time of the check-the-box election. Since the check-the-box election causes a deemed liquidation, the taxpayer believes that the liquidation, combined with insolvency, is an identifiable event which triggers a worthless stock and bad debt deduction.

ANALYSIS

Section 301.7701-1 of the Treasury Regulations governs the classification of organizations for federal tax purposes. Under Treas. Reg. § 301.7701-3 (the "check-the-box" regulations), a taxpayer may elect its classification as either an association or a partnership. A taxpayer may elect to change its classification 60 months from the effective date of the election. Treas. Reg. § 301.7701-3(c)(1)(iv). When a taxpayer elects to change its classification it is treated as a "deemed" liquidation of the corporation.

There is no dispute over the propriety of the taxpayer's election under section 7701, or the deemed liquidation treatment of the foreign entities. The examination team disputes the taxpayer's claim for a worthless stock and bad debt deduction under sections 165 and 166 in conjunction with the check-the-box election. We agree that the taxpayer is not entitled to worthless stock and bad debt deductions in this case.

Section 165 of the Internal Revenue Code allows a taxpayer to claim a deduction of the loss that results when stock becomes worthless during the taxable year. Section 1.165-1(b) of the Treasury Regulations provides that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and

completed transactions, fixed by identifiable events, and actually sustained during the taxable year. There is a two-part test to determine whether a stock is worthless. First, it must be shown that the business entity is insolvent. Morten v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), affd. 112 F.2d 320 (7th Cir. 1940). Current balance sheet insolvency alone is not enough to establish worthlessness. Second, the taxpayer must demonstrate the absence of any reasonable expectation of future solvency or potential value. Morten v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), affd. 112 F.2d 320 (7th Cir. 1940); Wally Findlay Galleries Int'l, Inc. v. Commissioner, T.C. Memo 1996-293 (1996). A complete lack of potential value is usually demonstrated by the occurrence of an identifiable event which signals to stockholders and other interested parties that there is no potential value to the stock. Morten. There is no definite legal test for this identifiable event, but it is often a closed and completed transaction such as bankruptcy, receivership, cessation of business, sale of assets, or surrender of corporate charter. The substance of the transaction, rather than mere form, governs the determination of a deductible loss. In addition, the taxpayer bears the burden of proving worthlessness. Boehm v. Commissioner, 326 U.S. 287, 294 (1945); Figgie International, Inc. v. Commissioner, 807 F.2d 59 (6th Cir. 1986)

Numerous courts have followed the two-part test for determining worthlessness laid out in Morten, namely, an insolvent entity and a total lack of future potential value. See e.g. Figgie International, Inc., supra; Corona v. Commissioner, T.C. Memo. 1992-406, aff'd without opinion, 33 F.3d. 1381 (11th Cir. 1994), cert. denied, 513 U.S. 1094; Wally Findlay Galleries, supra; Greenberg v. Commissioner, T.C. Memo. 1971-220.

Insolvency

The taxpayer must show that the *bona fide* debts of the entity exceed the value of the assets. Thus it is important to examine the debts owed to the parent corporation to confirm that they are *bona fide* debts and not equity. The taxpayer asserts that all [redacted] entities for which the check-the-box election was made were insolvent at the time of the election. The IRS exam team agrees that [redacted] and [redacted] were insolvent at the time of the election. However, the IRS exam team does not agree that [redacted] was insolvent. In addition, much of the debt of the foreign entities was owed to the parent corporation. Further inquiry is necessary to determine whether all of the debt was actually *bona fide*.

Even if the taxpayer can establish *bona fide* insolvency, if

the corporation has any potential future value, it can not be deemed to be worthless. See Morton, supra.

Lack of Potential Value

Lack of potential value can be shown where liabilities so exceed the assets there is no hope of recovery. Morten, supra. This has not been shown or even asserted to be the case here. Therefore, the taxpayer must be able to point to some identifiable event which fixes the hopelessness of the company's chance of future value.

Whether the stock of a company is worthless is a factual determination. Boehm, 326 U.S. at 293. There is no definitive test for the worthlessness of a stock. Therefore, the courts will consider all of the surrounding facts and circumstances.

The occurrence of only one identifiable event may not be sufficient to render the stock worthless. In fact, most of the relevant cases find a company worthless only after the occurrence of several events. See Murray v. Commissioner, T.C. Memo. 2000-262; Osborne v. Commissioner, T.C. Memo. 1995-353, aff'd, 114 F.3d 1188 (6th Cir. 1997). Rather, the event, or series of events must signal to a reasonable observer, not just the shareholders, that there is no hope of recovery or of future value. Therefore, the mere occurrence of one of the listed events is not determinative. The courts will also consider whether the identifiable event is one that can be undone in the future. See Slater v. Commissioner, T.C. Memo. 1989-35; Tippen v. Commissioner, T.C. Memo. 1988-284. If so, it is less likely to indicate worthlessness. A check-the-box election can be "undone" with another check-the-box election after sixty months.

There is also a distinction between the restructuring of an old corporation which continues its business under a new structure and the total dissolution of a corporation and the distribution of all of its assets. The latter would tend to indicate that the stock is worthless.

It is important to note that, for federal tax purposes, a deemed liquidation should be treated as an actual liquidation, and cannot be distinguished otherwise simply because it is "deemed." A deemed liquidation under the present facts can be distinguished from circumstances where a corporation is liquidated and its assets are dispersed. In those circumstances, it is impossible for the taxpayer to recover its investment because there is "no prospect that he would receive any more." See Ditmar v. Commissioner, 23 T.C 789, 798 (1955), acq. 1955-2 C.B. 5. See also Drachman v. Commissioner, 23 T.C. 558 (1954),

acq. 1955-2 C.B. 5, where assets were taken over by creditors who planned to liquidate the corporation in order to satisfy their own claims.

Although a complete liquidation of an insolvent corporation *may* be an identifiable event, it does not necessarily indicate worthlessness. When a company chooses a "deemed" liquidation under section 7701 (checks-the-box), it does not destroy the value of the subsidiary company. A check-the-box deemed liquidation or a corporate restructuring is not the type of event which signals to interested parties that the stock is worthless and lacks any potential value. Especially where, as here, the businesses continue to operate uninterrupted, [redacted] may elect to reclassify the subsidiaries sixty months in the future (thus undoing the check-the-box election), and [redacted] has not demonstrated any belief that it will not be able to recover its investment and in fact, has stated that the subsidiaries are expected to become profitable.

Consistent with the "no future value" requirement, section 165 does not allow a deduction for worthless stock if the taxpayer is compensated, by insurance or otherwise, for the loss. Likewise, in order for a worthless stock loss to be sustained, the taxpayer must suffer an economic loss. Commissioner v. Fink, 483 U.S. 89, 97-98 (1987). The facts of the instant case do not indicate that the taxpayer suffered an actual economic loss upon the deemed liquidation of its subsidiaries' stock.

The taxpayer cites Rev. Rul. 70-489 and Rev. Rul. 63-107 as support for its position. Rev. Rul. 70-489 involved a bad debt deduction under section 166 by the parent-creditor corporation for debts of a wholly-owned subsidiary. The subsidiary's insolvency was due to its *bona fide* debts to the parent. The subsidiary was merged into the parent and all of its assets were transferred to the parent in satisfaction of the debt. The parent then continued to operate the subsidiary as a branch. There was a factual determination that the stock of the subsidiary became worthless. The worthlessness of the stock was not a legal conclusion. Furthermore, the factual finding of worthlessness would not have been necessary if it were clear that the liquidation destroyed the value of the stock. Although this situation is similar to [redacted]'s because the subsidiaries are insolvent and the business continues to operate, the difference is in the *bona fide* debt owed to the parent (which has not been established by [redacted]), the actual liquidation of the subsidiary's assets, and the factual determination that the stock had become worthless prior to liquidation to the parent.

Revenue Ruling 63-107 involved an involuntary change in the

status of a corporation due to a change in the applicable regulations. Where the status of the association converted from a corporation to a partnership solely by operation of the regulations, and no action was taken to change the structure of the entity, the change in classification by itself did not constitute a dissolution or liquidation of the association. Therefore, no gain or loss was recognized under section 331. Revenue Ruling 63-107 did not address deductions for worthless stock or bad debts under sections 165 and 166.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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By: /s/
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